

FORWARD CONTRACTING—SELLING CROPS BEFORE HARVEST

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"Contract your crop—fix your price before harvest and eliminate some price risk" is becoming a common phrase throughout rural Texas as agricultural prices show more fluctuation. Forward contracting of crops is a financial tool, a marketing tool and a management tool that removes some of the uncertainty from farming.

This fact sheet identifies legal components of an enforceable contract, explains some advantages and disadvantages of forward contracting and gives items for consideration before entering into a forward contract.

Legal Components

A contract is an agreement, enforceable in court, between two or more persons for a sufficient consideration to do a specific act. A typical forward contract for an agricultural crop is a written agreement made before the crop is harvested for the producer to deliver a crop at a specified time, place and price to the buyer.

The following are five requirements for a legally enforceable contract for agricultural crops:

- date the contract was made and signed.
- price of the product or a formula indicating how price will be determined.
- delivery conditions specifying product identification, quality standards, quantity, place and date of delivery. The date is commonly established as "on or before (date)" to give producers some choice in delivery. If the exact quality product is not delivered, include a price benefit and discount schedule in the contract. Where possible, identify quality by a standard grading system. For example, cotton could be identified by grade, micronaire and staple. Quantity should also be specified, such as 400,000 pounds of grain at 14 percent or less moisture rather than 100 acres of grain sorghum.

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- specific performance expected of buyers and sellers. Include penalties for failure to meet contractual arrangements, such as conditions for forfeiture of any escrow payment.

- signatures of the persons involved.

Meeting these requirements will help overcome the two largest problems in forward contracting agricultural crops: buyers not taking delivery at a prearranged payment rate and sellers not delivering the stipulated product quantity or quality. Verbal contracts are also legal obligations, but written contracts help prevent misunderstandings.

Advantages

Forward contracting offers several advantages to farmers.

Less financial risk. Because the price of the product to farmers is fixed, buyers must bear the risk of market price fluctuations.

Greater financial leverage. A fixed product price may allow farmers to borrow more operating capital. Lending institutions often are more willing to extend loans to farmers who have a guaranteed price for their product. This factor becomes more important as the size of farming operations increases.

Financial planning. Producers who have part of their crops sold at a fixed price can use this information to plan the next year's capital expenditures.

Disadvantages

Disadvantages of forward contracting must also be considered.

Limited profit. Any increase in product market price above the contract price benefits purchasers rather than producers since the contract fixes the price.

Quality may suffer. Unless product quality standards are emphasized in the contract, farmers may concentrate on quantity produced rather than product quality improvement.

Quantity stipulations. Producers who sign contracts with a stipulated quantity (such as 400,000 pounds of sorghum) must deliver that quantity. If production is below the quantity contracted, sellers must arrange to purchase other grain to meet the contract arrangements or be prepared to pay a penalty.

Legal fees. Attorney fees for reviewing or writing contracts may be an added expense.

Other Considerations

Consider several other factors before entering into a forward contract for your crops.

Emotional contingencies. As a producer, are you willing to live with the established price? How much will you worry if prices go above the contract price?

Buyer's financial strength. Do you know if the buyer has the financial resources to meet his contractual obligation? Checking the buyer's credit may be necessary.

Producer's financial strength. If you have a short crop, can you purchase the necessary product to meet your contractual delivery obligations? In light of this, some producers only contract for part of their expected production.

Future price expectations. Predicting prices for any product is difficult, but the long time span between contracting and delivery of a crop makes price predictions for forward contracting even more difficult. Chances for accuracy decrease as the time period increases.

Producer's financial status. Will entering into a forward contract allow you benefits of greater leverage and better financial planning? Some financially sound producers may not realize these advantages.

This fact sheet is written for educational purposes and is not intended as any form of legal service. Only attorneys should be contacted for legal advice.

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